Internal Revenue Service

memorandum

CC:TL-N-5488-88
Br2:JKHarris

date: JUL 13 1988

to: District Counsel, [redacted]
Attn: [redacted] CC:[redacted]

from: Director, Tax Litigation Division CC:TL

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subject: [redacted]

This is in reference to your memorandum of February 10, 1988, addressed to the General Litigation Division, in which guidance is requested concerning whether the Service should recommend to the Department of Justice initiation of an erroneous refund suit against the above-named taxpayer to recover refunds paid on claims involving investment credits.

FACTS

[redacted] is a taxpayer in the Coordinated Examination Progam (CEP) in the [redacted] District. [redacted]'s principal place of business is [redacted], and its returns are filed with the Austin Service Center. On [redacted], [redacted] filed Forms 1120X, Amended U.S. Corporation Income Tax Returns, for its fiscal years [redacted] through and including [redacted]. [redacted]'s claims for refund for [redacted] through [redacted] have not been paid; tax years [redacted] and [redacted] are currently under examination as a CEP case.

However, [redacted]'s claims for refund for [redacted] and [redacted] were paid in full by the Austin Service Center on May 25, 1987. In [redacted], during the course of a general program examination of its [redacted] and [redacted] returns, [redacted] and the Service had executed a Form 872 to extend the statute of limitations for assessment to [redacted]. Therefore, pursuant to I.R.C. § 6511(c), [redacted]'s claims were timely filed.

[redacted]'s claims for refund on Forms 1120X for [redacted] and [redacted] were based on the following adjustments to its original returns: (1) Decreases to capital gains and contributions expense as a result of carryback losses for tax years [redacted] and [redacted]; and (2) increases in depreciation and investment credits for central heating, ventilating and air conditioning systems installed in retail supermarkets in reliance on Piggly Wiggly Southern, Inc., et al. v. Commissioner, 84 T.C. 739 (1985), aff'd, 803 F.2d 1572 (11th Cir. 1986). The total refunds paid to [redacted] for [redacted] and [redacted] were $[redacted]; of this amount, $[redacted] is solely attributable to increases in depreciation and investment credits on central HVAC systems.

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[redacted]'s claims for refunds were not considered by the Examination Division or Appeals. The Service took no position on the HVAC issue for taxpayer's [redacted] and [redacted] tax years either during the general program examination or during the consideration of the claims for refund in the Service Center. The claims were apparently routinely math verified and approved for payment in the Service Center. Although sufficient in amount to require referral to the Joint Committee, the claims for refund were not in fact referred to the Joint Committee prior to payment.

LAW

For the years in issue, I.R.C. § 38 allowed as a credit against federal income tax the investment credit defined by section 48 and determined under section 46(a).

Section 48(a)(1) defines "section 38 property," in part, to mean tangible personal property (other than an air conditioning or heating unit), or other tangible property (not including a building and its structural components) but only if such [other tangible] property is used as an integral part of manufacturing, production or extraction, or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services.

Treasury Regulation § 1.48-1(c) defines tangible personal property to mean any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). Similarly, Treas. Reg. § 1.48-1(d)(1) provides, generally, that any other tangible personal property (but not including a building and its structural components) used in certain activities specified in section 48(a)(1)(B) may qualify for the investment credit. [Emphasis supplied]

Treas. Reg. § 1.48-1(e)(2) defines "structural component" to include, inter alia, all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts. This regulation further states that "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. [Emphasis supplied]

DISCUSSION

In Piggly Wiggly, the Tax Court concluded that HVAC units installed in the taxpayer's retail food supermarkets were eligible for investment credit under the "sole justification" rule of Treas. Reg. § 1.48-1(e).

It is the view of the Service that the Tax Court's decision in Piggly Wiggly is erroneous. The Tax Court erred in failing to properly apply the "sole justification" test of Treas. Reg. § 1.48-1(e)(2) to the issue raised. In addition, the Tax Court failed to properly follow existing Tax Court, as well as appellate, precedent in Piggly Wiggly.

The specific exclusionary language of section 48(a)(1) is fully and explicitly supported by its legislative history. H. Rept. No. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 405, 515, states that "the term 'structural components' of a building includes such parts of the building as central air-conditioning and heating systems, . . . relating to the operation and maintenance of the building." See also S. Rept. No. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 707, 859, where substantially identical language is used in defining "structural components."

Further, these Treasury Regulations have been explicitly approved by Congress as being an accurate reflection of Congressional intent in originally enacting the investment credit. See H. Rept. No. 749, 88th Cong., 1st Sess. 41 (1963), which states:

> The proposed [investment credit] regulations issued by the Treasury Department with respect to the term 'structural components' provide an extensive list of the type of items considered to be structural components and therefore not eligible for the investment credit . . . these regulations are an accurate interpretation of the intention of Congress last year in this respect.

See also S. Rept. No. 830, 88th Cong., 2d Sess., 41 (1963), 1964-1 C.B. 505, 545, which contains an identical statement.

In conformity with this legislative intent, the longstanding position of the Service is that central air conditioning systems are structural components of buildings and are not eligible for investment credit. Rev. Rul. 67-359, 1967-1 C.B. 9; Rev. Rul. 67-417, 1967-2 C.B. 49. 1/

1/ There was no dispute in Piggly Wiggly that the HVAC units created a central air conditioning system. 84 T.C. 739, f.n. 6. Therefore, the analysis of whether the HVAC units are eligible for investment credit as structural components under section 48(a)(1)(A) is made without consideration of the parenthetical reference to air conditioning units; that parenthetical reference concerns individual air conditioning units, not central air conditioning systems. See Rev. Rul. 81-240, 1981-2 C.B. 11.

Notwithstanding the statute, legislative history and Congressionally approved legislative regulations, the Tax Court, while acknowledging that the taxpayer's HVAC units were structural components of buildings as defined in Treas. Reg. § 1.48-1(e)(2), nevertheless concluded that the taxpayer was entitled to claim the investment credit on the HVAC units because "the sole justification for the installation of the HVAC units was the necessity to meet the temperature and humidity requirements of the refrigeration equipment [open front food freezer display cases] in petitioner's stores."

This conclusion by the Tax Court was not supported by the record, which clearly demonstrated (through testimony of the taxpayer's refrigeration manager) that while the specific HVAC units that were installed did enhance the operating efficiency of the open front freezer food display cases, the taxpayer also recognized and expected that the HVAC units would provide air conditioning for the comfort of its customers and employees.

That is, the record in Piggly Wiggly established that customer comfort was a substantial motivating factor, if not one of equal weight, in the taxpayer's decision to install the HVAC units. Where there is more than one substantial reason for installation of what otherwise is conceded to be a structural component of a building, the sole justification test of Treas. Reg. § 1.48-1(e) cannot be met. In holding that the taxpayer in Piggly Wiggly met the sole justification test on the basis of the factual record before it, the Tax Court erred in its application of the regulation and effectively substituted a "primary purpose" test. A primary purpose test is not the sole justification test mandated by the regulations, and such a primary purpose test is clearly inconsistent with the regulation.

In addition, the Piggly Wiggly decision conflicts with prior decisions of the Tax Court on the eligibility of air conditioning systems for investment credit and failed to acknowledge the implicit direction of the Fifth Circuit on this issue.

In Kramertown Co., Inc. v. Commissioner, T.C. Memo. 1972-239, aff'd, 488 F.2d 59 (5th Cir. 1974), the Tax Court concluded that rooftop air conditioning units were structural components of a building and therefore ineligible for investment credit. See also Dixie Manor, Inc., v. United States, 79-2 U.S.T.C. para. 9469 (W.D. Kan. 1979), aff'd without published opinion, 652 F.2d 57 (6th Cir. 1981); Fort Walton Square, Inc. v. Commissioner, 54 T.C. 655 (1970).

Moreover, in Circle K Corp. v. Commissioner, T.C. Memo. 1982-298, the Tax Court correctly addressed the issue of the eligibility for investment credit of air conditioning units installed in retail food stores, albeit convenience stores as opposed to supermarkets. In Circle K, the Tax Court rejected petitioner's arguments that the air conditioning units were not structural components because of their removability.

More importantly, the court rejected the petitioner's argument that the air conditioning units were eligible for investment credit because they were installed to meet temperature or humidity requirements of its business, i.e., to prevent spoilage of foodstuffs. In rejecting this argument, the court stated:

> Nevertheless, it is clear that this exception [sole justification] is inapplicable to the instant case. First, the air conditioning units were not essential to the operations of any machinery or the processing of materials or foodstuffs. Petitioner did not process foodstuffs, but simply marketed them. 2/ Second, the record indicates that the problems caused by the evaporative coolers during high humidity periods could have been eliminated by simply not using the coolers, but such a course of action would have placed petitioner at a competitive disadvantage. Consequently, we believe that a substantial reason for the installation of the air conditioning units was to provide for the comfort of petitioner's customers, a purpose that is outside the scope of the regulatory exception relied upon by petitioner.
>
> In conclusion, we hold that the air conditioning units installed by petitioner constitute structural components of the building and, therefore, do not qualify as section 38 property. [Emphasis supplied]

The conclusion of the Tax Court in Circle K is a correct analysis of the issue in the context of the applicable regulations. In Piggly Wiggly, however, the court accepted the taxpayer's distinction of Circle K, but it is a distinction without merit. A mere difference in operating size between the convenience stores considered in Circle K and the supermarkets considered in Piggly Wiggly is not a significant enough distinction to support a completely opposite result. Moreover, in Piggly Wiggly, the court ignored the analysis in Circle K that considered whether customer

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2/ The Piggly Wiggly court also concluded that activities incidental to the retail sale of meat were not processing or manufacturing of foodstuffs, citing Rev. Rul. 81-66, 1981-1 C.B. 19, with approval. See also Morrison, Inc. v. Commissioner, T.C. Memo. 1986-129.

comfort was a "substantial reason" for installation of the HVAC units. Each taxpayer is a grocery retailer operating in a highly competitive environment that requires cognizance of customers' comfort to retain a profitable market share. Also in Circle K the court clearly did not accept inefficient operation of machinery and equipment [evaporative coolers] as sufficient grounds to meet the sole justification rule of Treas. Reg. § 1.48-1(e)(2).

On appeal, Piggly Wiggly Southern, Inc., et al v. Commissioner, 803 F.2d 1572 (11th Cir. 1986), the appellate court recapitulated the conclusions of the Tax Court in the following manner: (1) Treas. Reg. § 1.48-1(e)(2) is an accurate interpretation of Congressional intent regarding the tax treatment of heating and air conditioning equipment and has the full force and effect of law; (2) the evidence presented to the Tax Court clearly established that the sole justification for the installation of the HVAC units was to meet temperature and humidity requirements of other machinery and equipment; and, (3) little weight was assigned to the evidence presented by the Commissioner to demonstrate that the taxpayer installed the HVAC units primarily for customer and worker comfort.

The Eleventh Circuit rejected the Government's argument that the Tax Court had applied an incorrect legal standard in Piggly Wiggly. The appellate court specifically declined to apply the "adaptable to other operations" test established by the Fourth Circuit in A. C. Monk & Co. v. United States, 686 F.2d 1058 (4th Cir. 1982), with regard to the eligibility of a primary electrical system of a factory building for the investment credit. The Eleventh Circuit concluded that application of the Monk standard to machinery and equipment that had been determined by the fact finder to meet the sole justification test would read a specific relief exception out of regulations that have the force and effect of law.

The Eleventh Circuit also rejected the Government's contention that the Tax Court had misinterpreted the sole justification test by not recognizing that sole justification means "exclusive" justification. The court commented that the Government's asserted error of law on this point pre-supposed a factual finding contrary to that of the Tax Court. The appellate court further stated that the sole justification test "necessarily involves a factual determination as to why the taxpayer made particular expenditures" and declined to conclude as a matter of law that a taxpayer in Piggly Wiggly's situation would not have purchased and installed HVAC units to meet temperature and humidity requirements of open front food freezer display cases.

Finally, the Eleventh Circuit explicitly rejected the Government's argument that the Tax Court's factual findings in Piggly Wiggly were incorrect. The appellate court concluded that under the "clearly erroneous" standard, the Tax Court's choice between two permissible views of evidence cannot be overturned. Anderson v. City of Bessemer City, 470 U.S. 564 (1985).

The Service disagrees with the conclusion of both the Tax Court and the Eleventh Circuit. An Action on Decision has been prepared to announce nonacquiesence in the Tax Court decision and that the issue will continue to be litigated in cases where appeal does not lie to the Eleventh Circuit.

The eligibility of HVAC systems for investment credit is currently being pursued in the Tax Court and in the Claims Court. Two cases were recently tried in the Tax Court in the Western Region. [redacted], has a proposed deficiency of $[redacted] for tax year [redacted]. [redacted], has a proposed deficiency of $[redacted] for tax years [redacted]. Further, [redacted], a refund suit for $[redacted] for tax years [redacted], is currently being prepared for trial in the Claims Court. One of several investment credit issues in [redacted] is investment credit on HVACs installed in its [redacted] restaurants. In its administrative claims for refund, the taxpayer relied on the sole justification rationale of Piggly Wiggly.

In these cases, in addition to arguing the specific provisions of legislatively approved regulations, this Division has recommended that an expanded record be established in the trial court. Thus, in [redacted] and [redacted], District Counsel, San Francisco, hired both a marketing expert witness and an engineering expert witness. The purpose of the marketing expert witness is to demonstrate that the taxpayers installed HVAC systems to remain competitive from a marketing point of view (i.e., for customer comfort and ambiance). The purpose of the engineering expert witness is to demonstrate that the taxpayers were required to install HVAC systems to meet building code requirements or health and safety standards. It is anticipated that the engineering expert witness will be able to establish the proportion of the HVAC systems' capacity that is dedicated to refrigeration equipment as opposed to general purpose heating, air conditioning and ventilation.

Therefore, it is the position of the Service that the Piggly Wiggly issue should be pursued in the context of an erroneous refund suit against [redacted]. Because the burden of proof in an erroneous refund suit is on the Government, one possible ground for the erroneous refund suit could be the Service's failure to refer the refund to the Joint Committee pursuant to section 6405.

However, our research discloses that such a curable, procedural irregularity may not be a sufficient legal ground for initiation of an erroneous refund suit, see Oxford Life Insurance Co. v. United States, 574 F.Supp. 1417 (D. Ariz. 1983), aff'd, rev'd and rem'd on other issues, 790 F.2d 1370 (9th Cir. 1986). If failure to refer a refund to the Joint Committee is curable, as implied by the Oxford Life court, pleading only this ground would not likely result in shifting the burden of proof on the substantive issue to the taxpayer. [3/] Thus, it appears that the Government will be required to litigate the merits of the Piggly Wiggly issue in the erroneous refund suit.

Consequently, because the burden of proof is on the Government, it is essential to proceed only with a fully developed case. Therefore, District Counsel should advise the Department of Justice promptly of our intention to authorize an erroneous refund suit but request the Department to delay filing the suit until shortly prior to the statutory expiration date, May 29, 1989. District Counsel should also inform Examination that [redacted]'s [redacted] and [redacted] years should be thoroughly developed on the HVAC issue. [4/] Examination should be further informed that without a fully factually developed case, it is unlikely that District Counsel will continue to support prosecution of an erroneous refund suit.

If District Counsel is unable to secure a satisfactorily developed case from Examination prior to the expiration of the statute under section 7405, the taxpayer should be requested to extend the statute. [5/] Should the taxpayer decline to extend the statute of limitations, District Counsel should continue to attempt to develop the case with Examination until approximately two months prior to the expiration of the statute. At that time, District Counsel should consult with the Department of Justice to determine whether development of the case can be satisfactorily completed by the Department through discovery.

[3/] This Division will explore with the Joint Committee staff the procedure for referring the refund paid to [redacted] for [redacted] and [redacted] on the basis of the Piggly Wiggly case to the Joint Committee for its review.

[4/] The CEP Manager on [redacted]'s current audit cycle has informally advised this office that Examination will be able to fully develop the HVAC issue for [redacted] and [redacted].

[5/] The General Litigation Division has concluded in the attached memoranda that the statute of limitations under section 7505 may be extended by agreement of the parties, notwithstanding a lack of specific statutory authority.

If the taxpayer agrees to extend the statute, and we have been unable to secure a satisfactorily developed case by the expiration of the statute, District Counsel and the Department of Justice should determine that the statute has been validly extended and continue to attempt to develop the case while awaiting decisions from the Tax Court and the Claims Court.

We are prepared to render further assistance to your office, as necessary.

MARLENE GROSS
Director
Tax Litigation Division

By: Judith M. Wall
JUDITH M. WALL
Senior Technician Reviewer
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Attachments
GL Memoranda

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